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Accounting Questions: Accrual of Capital-Stock Tax, Bank Requirements in Granting Loans, Interest on Bonds Purchased Though Sinking Fund

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Accounting Questions

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ACCRUAL OF CAPITAL-STOCK TAX

Question: The following problem was raised by one of our clients as to the proper accrual of the capital-stock tax. This capital-stock tax as far as the law is concerned appears to be definitely stated as imposed for the year ended June 30, 1933, and is payable on filing the report shortly thereafter, which appears to settle the question of accrual.

Our client, however, raises the point that this is at variance with common-sense and that accounting practice should be in accord with common-sense as well as technicalities. He points out that under this theory a company which started business on May 31, 1933, would charge an entire year's tax in one month and that any company with the calendar year as a fiscal year will have to charge this year's profits or surplus with tax for eighteen months.

He points out further that this tax is specifically imposed to meet the interest charges incurred by the federal government next year rather than this year.

While we feel there is a great deal of logic to our client's opinion, it seems rather hard to get away from the technicalities of the case.

Answer: We would first point out the difference between yearly accruals and monthly accruals. The purpose of the first is to bring into each year the charges appertaining to that year; the second to distribute a year's charges equally to each month of that year. Naturally such charges differ in amount from year to year but from month to month in any particular year may be equalized.

We find no warrant in common-sense or in accounting practice for neglecting to accrue a liability when it is definitely determined, regardless of whether it be more or less than a similar liability in some other year. This does not prevent charging profit-and-loss with the correct amount for the fiscal year. Any portion that applies prior may with propriety be charged to surplus and any portion that applies subsequently may properly be held up as a prepaid expense.

BANK REQUIREMENTS IN GRANTING LOANS

Question:

1. Do banks require any special procedure for verification when a balance-sheet is issued?
2. Do they lend on general credit of company without any additional protection?
3. What type of certificate do the banks require?
4. What is the nature of certificate when various types of audits are made?

Answer: In reply to the first question I would say that when a bank receives an audit report it expects that all figures contained in the audit have been verified, dependent, however, on the auditor's certificate, which should accompany every balance-sheet. The procedure of verification is, however, not important.

The second question can be answered in the affirmative. Banks extend credit to commercial companies on the basis of their financial standing and their experience, without collateral. Of course, in the extension of credit a signed note of the borrower is lodged with the lending bank as an evidence of indebtedness. When clean credit is extended there is no additional protection.

In reply to your third question I would say that the banks try to obtain as complete a certificate as possible, and where there are exceptions in the certificate the bank may ask for additional information or if necessary ask for an audit by an accountant favorably known to the bank.

The fourth question is partly answered above and in brief would say that the certificate should cover the particular type of audit that is made. In other words, the certificate tells the bank the extent of the audit.

INTEREST ON BONDS PURCHASED THROUGH SINKING FUND

Question: A corporation, which is obligated to deposit periodically with the trustee of the sinking fund for a bond issue a stipulated amount, has followed the practice of treating as part of the cost of the bonds the accrued interest paid to the trustee of the sinking-fund when buying bonds. That is, on the books of the corporation, when the trustee reports the purchase, the corporation credits the trustee for the sinking-fund with the total amount paid for the bonds, including accrued interest, and credits or charges, respectively, its surplus account with the amount by which such purchase cost is less or more than the par value of the bonds bought and canceled.

In our opinion the accrued interest paid on the bonds so purchased and retired should be charged against the account which is periodically credited for interest accruing on the outstanding bonds, and only the amount paid to the sinking-fund trustee or the bonds themselves (exclusive of accrued interest) should be compared with the par value to determine the difference between the retirement cost and par value of such bonds.

What is the proper procedure to be followed among corporations having bonds outstanding and making periodical payments to the sinking-fund trustee for retirement of such bonds through purchase in the market?

Answer: This question can best be answered by means of a simple illustration. Let us assume that a corporation met its obligation with respect to sinking-fund by paying $10,000 into the hands of the trustee. Thereupon the trustee purchased ten bonds at 90, with accrued interest of $150, a total of $9,150. The bonds were then canceled. It is explained in the query that entries which are made on the books of the corporation charge the trustee with the sinking-fund deposit, credit the trustee with the cost of the bonds plus accrued interest and credit surplus with the difference between the face value of the bonds and the amount paid for the bonds, including accrued interest.

The credit to surplus in the case cited above would be $850. It would appear that the transaction has not been completely recorded on the books at this point, inasmuch as the accrued interest on the bonds is still in the accrued-interest account, and a further entry charging accrued interest with $150 and crediting surplus with the same amount would be necessary. If this entry were made, surplus would have been credited with $1,000, representing the difference between the face amount of the bonds and the cost of the bonds excluding accrued interest.

The only principle involved, as we see it in this case, is that the income of the corporation should be charged with the full amount of interest on bonds outstanding, including the bonds which are purchased by the trustee up to the date of such purchase.

The entries outlined above, while recording the transaction, do not record it in the best manner. The entry should be as follows:

Bonds....................................	$10,000	
Accrued interest...........................	150	
To Trustee..............................		$9,150
Surplus..............................		1,000